Committee On Finance
Max Baucus, Chairman

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STATEMENTS BY CHARIMAN MAX BAUCUS AND RANKING MEMBER CHARLES GRASSLEY SENATE FINANCE COMMITTEE TAX SHELTER TRANSPARENCY ACT

Garrison Keilor is quoted as saying, "I believe in looking reality straight in the eye and denying it." That approach is perhaps what some would like us to do with respect to the increasing problem of the use of abusive tax shelters to avoid or evade taxes. But I do not agree.

The *Tax Shelter Transparency Act* that I introduce today doesn't deny reality – rather, it shines some transparency on reality so that we have a better understanding of what is going on out there. Following Enron's bankruptcy, I think that all Americans have a greater appreciation for the need for greater transparency in complex tax transactions.

The legislation is the product of over two years of review and public comment. The Tax Shelter Transparency Act also incorporates tax shelter proposals released by the Department of Treasury the day before the Senate Finance Committee's March 21, 2002 hearing on the subject.

As I stated at the hearing, "the Finance Committee is committed to helping combat these carefully engineered transactions. These transactions have little or no economic substance, are designed to achieve unwarranted tax benefits rather than business profit, and place honest corporate competitors at a disadvantage."

The proliferation of tax shelters has been called "the most significant compliance problem currently confronting our system of self-assessment." Less than two years ago, there was a more positive outlook regarding the government's ability to curb the promotion and use of abusive tax shelters. The Department of Treasury and the IRS issued regulations requiring disclosure of certain transactions and requiring developers and promoters of tax-engineered transactions to maintain customer lists. Also, the IRS had prevailed in several court cases against the use of transactions lacking in economic substance.

Unfortunately, the honesty and integrity of our tax system has suffered significant blows over the past two years. Court decisions have shifted from decisions tough on tax avoidance and evasion to court defeats for the IRS. Also, there appears to be a lack of compliance with the disclosure legislation passed in 1997 and the subsequent regulations.

The corporate tax returns filed in 2001 are the first returns filed under the new tax shelter disclosure requirements. The Administration provided the Finance Committee with the results of their analysis of the disclosure data, including their analysis of what was not disclosed.

Only 272 transactions were disclosed by 99 corporate taxpayers. There are approximately 100,000 corporate taxpayers under the Large and Midsize Business Division at the IRS yet only 99 of them made a disclosure under the current regime. Based on the Finance Committee hearing, it is safe to say that the Administration, as did Congress, thought the number of disclosures would be much greater.

Clearly, the past method of reactive, ad-hoc closing down of abusive transactions does little to discourage the creation and exploitation of many shelters.

These transactions may be good for a corporation's bottom line, but they are bad for the economy. Here's why: abusive corporate tax shelters create a tax benefit without any corresponding economic benefit. There's no new product. No technological innovation. Just a tax break.

As with the Senate Finance Committee draft legislation released last August, the *Tax Shelter Transparency Act* emphasizes disclosure. Disclosure is critical to the Government's ability to identify and address abusive tax avoidance and evasion arrangements. Under the bill, if the taxpayer has entered into a questionable transaction and fails to disclose the transaction, then the taxpayer is subject to tough penalties for not disclosing and higher penalties if an understatement results.

The legislation separates transactions into one of three types of transactions for purposes of disclosure and penalties: Reportable Listed Transactions, Reportable Avoidance Transactions, and a catch-all category for Other Transactions. The legislation also addresses the role of each of the players involved in abusive tax shelters: including the taxpayer who buys, the promoter who markets, and the tax advisor who provides an opinion "endorsing" the tax-engineered arrangement. The legislation focuses on each of these participants and contains proposals to discourage their participation in abusive tax transactions.

Taxpayers

Reportable Listed Transactions

Reportable Listed Transactions are transactions specifically identified by the Department of Treasury as "tax avoidance transactions." These are transactions specifically classified by Treasury as bad transactions – essentially the worst of the worst.

Failure by the taxpayer to disclose the transaction results in a separate strict liability, nonwaivable flat dollar penalty of $200,000 for large taxpayers and $100,000 for small taxpayers.

Additionally, if the taxpayer is required to file with the Securities and Exchange Commission, the penalty must be reported to the SEC. If the taxpayer discloses the questionable transaction, they are not subject to the flat dollar penalty or the SEC reporting. The SEC reporting requirement is a critical element to improving the disclosure of transactions. The amount of tax penalty is relatively insignificant to the tax benefits generated by abusive tax shelter transactions. Corporations, however, have a strong incentive not to trigger a penalty that must be reported to the SEC.

Failure to disclose a reportable listed transaction that results in a tax understatement will be subject to a higher (30%) strict liability, nonwaivable accuracy-related penalty which must be reported to the SEC.

Reportable Avoidance Transactions

Reportable Avoidance Transactions are transactions that fall into one of the several objective criteria established by the Department of Treasury which have a potential for tax avoidance or evasion. Based on current regulations and the proposals put forward by the Administration, we anticipate these transactions would include but would not be limited to: significant loss transactions; transactions with brief asset holding periods; transactions marketed under conditions of confidentiality; transactions subject to indemnification agreements; and transactions with a certain amount of book-tax difference.

Failure by the taxpayer to disclose the questionable reportable avoidance transaction results in a separate strict liability, nonwaivable flat dollar penalty of $100,000 for large taxpayers and $50,000 for small taxpayers.

Reportable Avoidance Transactions are then subject to a filter to determine whether there is a significant purpose of tax avoidance. Transactions entered into with a significant purpose of tax avoidance are subject to harsher treatment in the form of higher penalties.

Promoters and Advisers

The legislation enhances the government's ability to enjoin promoters. Most significantly, the legislation increases the penalty imposed on tax shelter promoters who refuse to maintain lists of their tax shelter investors. If a promoter fails to provide the IRS with a list of investors in a reportable transaction within 20 days after receipt of a written request by the IRS to provide such a list, the promoter would be subject to a penalty of $10,000 for each additional business day that the requested information is not provided.

The legislation adds a provision authorizing the Treasury Department to censure tax advisors or impose monetary sanctions against tax advisors and firms that participate in tax shelter activities and practice before the IRS.

I am pleased that this legislation is the product of working closely with my good friend, and the Ranking Member of the Finance Committee, Senator Grassley. I appreciate Senator Grassley's cosponsorship of the *Tax Shelter Transparency Act* and his commitment to work as a bipartisan front to shine some light on these abusive tax shelter transactions.

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Statement of Senator Chuck Grassley
Ranking Member
Senate Committee on Finance
May 9, 2002
United States Senate

I rise today to co-sponsor legislation, the "Tax Shelter Transparency Act" which will arrest the proliferation of tax shelters.

We have known for many years that abusive tax shelters, which are structured to exploit unintended consequences of our complicated federal income tax system, erode the federal tax base and the public's confidence in the tax system. Such transactions are patently unfair to the vast majority of taxpayers who do their best to comply with the letter and spirit of the tax law. As a result, the Finance Committee has worked exceedingly hard over the past several years to develop three legislative discussion drafts for public review and comment. Thoughtful and well-considered comments on these drafts have been greatly appreciated by the staff and members of the Finance Committee. The collaborative efforts of those involved in the discussion drafts combined with the recent request for legislative assistance from the Treasury Department and IRS produced today's revised approach for dealing with abusive tax avoidance transactions.

Above all, the *Tax Shelter Transparency Act* encourages taxpayer disclosure of potentially abusive tax avoidance transactions. It is surprising and unfortunate that taxpayers, though required to disclose tax shelter transactions under present law, have refused to comply. The Treasury Department and IRS report that the 2001 tax filing season produced a mere 272 tax shelter return disclosures from only 99 corporate taxpayers, a fraction of transactions requiring such disclosure. The *Tax Shelter Transparency Act* will curb non-compliance by providing clearer and more objective rules for the reporting of potential tax shelters and by providing strong penalties for anyone who refuses to comply with the revised disclosure requirements.

The legislation has been carefully structured to reward those who are forthcoming with disclosure. I wholeheartedly agree with the remarks offered by the recent Treasury Assistant Secretary for Tax Policy, that "if a taxpayer is comfortable entering into a transaction, a promoter is comfortable selling it, and an advisor is comfortable blessing it, they all should be comfortable disclosing it to the IRS." Transparency is essential to an evaluation by the IRS and ultimately by the Congress of the United States as to whether the tax benefits generated by complex business transactions are appropriate interpretations of existing tax law. To the extent such interpretations were unintended, the bill allows Congress to amend or clarify existing tax law. To the extent such interpretations are appropriate, all taxpayers--from the largest U.S. multinational conglomerate to the smallest local feedstore owner in Iowa--will benefit when transactions are publicly sanctioned in the form of an "angel list" of good transactions. This legislation accomplishes both of these objectives.